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OIL AND GAS TAXATION

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It should be noted that this article on oil and gas taxation does not attempt to cover this field of law in any detailed manner, but is rather an attempt to set forth certain practical and general problems commonly met.

The first transaction which usually occurs in the search for oil and gas is the grant by the owner of the minerals, who is usually the owner of the surface land also, of an oil and gas lease to a second party. Generally, this lease calls for a bonus, which is the consideration for the lease, and an annual delay rental in the event drilling has not occurred during the year. The tax consequences of this transaction are as follows:

1. The lessor treats the bonus paid to him as an advance royalty and reports the full amount as income, deducting, however, 27½ percentage depletion.
2. The lessor treats the delay rentals as income. This income is not subject to depletion.
3. The lessee treats the bonus paid as cost of acquisition of the lease and capitalizes it. Two recent cases have held that in non-competitive federal leases the first year rental (which is very similar to bonus) can be expensed.[1]
4. The lessee can either expense the delay rentals or he can capitalize them under the special provisions of Internal Revenue Code Sec. 24 (a) (7).

The lessee now has a choice of attempting to explore for oil and gas himself or of assigning his lease to a third party. In the event that he decides on the latter course he has the choice of several different methods.

1. He can assign his lease to a third party for cash only. If he elects to follow this method he can treat the transaction as a sale and report as a capital gain the difference between his acquisition cost and the bonus which he received; unless he is a dealer engaged in oil and gas leases.
2. A second method of disposing of the leasehold would be to assign the same to a third party for a bonus and an overriding royalty. An overriding royalty has been defined as being a royalty which is retained by the lessee when he assigns the lease to another. In this case the assignor of the lease must treat the bonus received as ordinary income subject to percentage depletion, and his overriding royalty will be capitalized at the same cost as the original acquisition cost of his lease. The reason for this tax treatment is that since the assignor has reserved an economic interest in the oil and gas lease which lasts for the duration of the lease he is considered as having given only a sublease to the third party.

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[1] Hagwood v. United States, 53-5 Fed. Tax Rep. ¶9642.
Dougan v. United States, 53-5 Fed. Tax Rep. ¶ 9568.

3. A third alternative is for the assignor to assign the lease for a bonus and an oil payment. An oil or gas payment has been defined as being the right to receive a stated number of barrels of oil or a stated number of MCF of gas or a stated sum of money from a specified percentage of oil or gas production *only*, or the proceeds therefrom.[2] This type of transaction will be considered a sale and a capital gain on the bonus can be taken by the assignor if he is not engaged in the business.

4. The last alternative is for the assignor to assign in consideration of a bonus and a net profit interest. The net profit arrangement has been defined as being a contract which provides that the owner thereof shall receive a stated percentage of the net profits from the operation of the oil and gas property to which the contract refers. The law is not clear as to how this transaction is treated tax-wise, but the Bureau of Internal Revenue takes the position that it is a sublease rather than a sale. In light of the *Kirby Petroleum Co.* case, 326 U. S. 599, and the *Burton-Sutton Oil Company* case, 328 U. S. 25, the Bureau's position is justified.

Now let us suppose that the assignee of the lease desires to have a well drilled on the property. In this event he has the following choices:

1. He can drill it himself or finance its drilling with his own money, in which case he will be entitled to expense his intangible drilling costs. Intangible drilling costs represent expenditures which have no salvage value and roughly constitute 60% or more of the total cost of a producing well, or almost 100% of the cost of a dry hole. It should be pointed out, however, that if the taxpayer desires to expense his intangibles he must make his election by a clear statement in the return for the first taxable year in which such costs are incurred,[3] and this election is binding for all subsequent years. In the event that the taxpayer elects to capitalize the intangibles he has a further choice of expensing in the event of a dry hole but again must make said election.[4]

2. The owner of the lease can give an oil payment for having a well drilled thereon, in which case the driller or operator cannot expense the costs of drilling the well but must capitalize these expenses as the cost of his or its oil payment.[5] In the event of production the holder of the oil payment reports the income therefrom as straight income subject to either cost or percentage depletion. Of course, the income attributable to the oil payment is not reported as income by the holder of the lease.

[2] If security other than production is given, a mortgage rather than an oil payment is created. Anderson v. Helvering, 310 U. S. 404.

[3] Reg. 111, Sec. 29.23(m)-16.

[4] *Ibid.*

[5] Herndon Drilling Co. v. Commissioner, 6 T. C. 628.

3. The lessee can give a net profit interest in consideration of having a well drilled. From the language of the *Kirby* and *Burton-Sutton* cases, *supra,* it would appear that this transaction would be treated in the same way as an oil payment type transaction.

4. The lessee can enter into a carried interest arrangement. A carried interest arrangement occurs where one party referred to as the "carrying party") agrees to pay for the drilling and equipping of a well, and the second party (referred to as the "carried party") agrees to repay to the carrying party the proportionate share of the cost advanced, only from his (the carried party's) share of oil, if, as, and when produced from the lease. There are two different types of carried interests, one lasting for the duration of the lease, and the other for a limited time. The tax treatment in regard to this transaction is presently in a state of confusion, there being two different theories of the applicable taxation, which are as follows:

a. The joint venture theory treats both the carried and the carrying parties as though they are both owners of their proportionate interests (and in effect says that the carried party has merely received a loan from the carrying party), and under this theory the carrying party reports only his share of the intangible drilling expenses as well as income. The carried party reports his share of the income even though he may not actually receive any for the reason that it has been used to reimburse the carrying party. The case of *Reynolds v. McMurray,* 60 F. 2d 843, and *Commissioner v. J. S. Abercrombie Co.,* 162 F. 2d 338, followed this rule, except that neither case went into the expensing of intangibles. However, these cases are not conclusive since the carried interests involved in both cases were interests which lasted for the entire life of the lease.

b. The transaction is treated as though the carrying party has the entire interest until he has been reimbursed by the carried party. This theory is set forth in GCM 22730 and has been chiefly responsible for the popularity of the carried interest arrangement. Tax treatment under this theory allows the carrying party to expense 100% of the intangibles. He also must report as income subject to depletion 100% of the income from said well until he has been reimbursed by the carried party at which time he will only report his proportion as well as deducting his proportion of the expense. Likewise, after the payout or reimbursement, the carried party must report all income attributable to his share of the working interest.

5. The joint venture theory is one of the most commonly used methods of financing the drilling of a well. The owner transfers undivided working interests to others who pay for

the drilling and equipping of the well and who are in turn entitled to expense the intangibles for their proportionate share. The operator who has put up no money, of course, is not allowed to take any intangibles. Caution should be exercised under this type of arrangement in order to avoid having the joint venture treated as a corporation. Specifically, the contract should provide that each joint venturer is entitled to his share of oil and gas in kind.

In the event of production, the owner or owners of the working interest can sell the same and take a capital gain on the sale. There is some intimation, however, in a recent case [6] that a new property has come into being when production has been obtained and that therefore the six-month holding period does not commence until the date of production. This appears to be a far-fetched theory, but should be studied before selling one's working interest.

Internal Revenue Regulation 111, Sec. 29.105-1 [7] contains a special provision for the selling of a leasehold, and reads as follows:

> If the taxpayer by prospecting and locating claims, or by exploring or discovering undeveloped claims has demonstrated the principal value of oil or gas property, which prior to his efforts had a relatively minor value, the portion of the surtax imposed by Sec. 12, attributable to a sale of such property or of the taxpayer's interest therein shall not exceed 30% of the selling price. Shares of stock in a corporation owning oil or gas property do not constitute an interest in such property.

Often the sale of a producing leasehold is financed by an oil payment. One of the primary reasons for this method of financing the sale is the tax saving which is involved. In such a transaction the owner may sell to a second party, receiving his capital gain, and the second party then sells to a third party, taking back an oil payment. The third party is then in somewhat the same position as the buyer of a property subject to a mortgage, but, unlike the buyer of the average property subject to a mortgage, he does not have to report as income the money paid on the oil payment. Thus, the tax saving which is involved is apparent.[8]

In the event of a dry hole the owner of the lease may report as a loss his leasehold costs. However, caution must be exercised as to reporting this loss in the year in which the lease becomes worthless.

The owner of the minerals may sell them or an undivided interest therein and treat the same as a capital gain transaction

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[6] Petroleum Exploration v. Commissioner, 193 F. 2d. 59.

[7] 53-2 Fed. Tax Rep. ¶ 684.

[8] For an interesting article on oil payments and valuation thereof, see "*Valuation of Oil and Gas Producing Properties for Loan Purposes*," by Lyon F. Terry and Kenneth E. Hill, Petroleum Department, The Chase National Bank of the City of New York, February 17, 1953.

regardless of whether there has been a dry hole or production has been achieved.

It can readily be seen that a tremendous tax saving can be made by one desiring to participate in the finding of oil and gas, but that in order to take the benefit of said savings great care should be exercised not only in setting up the transaction but also in drafting the necessary instruments.

COURT ROOM DECORUM*

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A strong desire for democracy has caused most Americans to resent a severe formality in any procedure. The reaction has been to deteriorate decorum in many of our courts, especially the lower courts; and to cause many laymen to lower their respect for both judges and lawyers. Even the "dusty foot" courts of England might not compare so unfavorably with some of our police courts.

It is difficult for a judge to change the conduct of the lawyers, because he also prefers to be democratic. For this reason many of our judges have refused to wear robes. The lawyers are his friends, and he is careful not to embarrass them by reprimands before their clients.

Every lawyer should remember that in deed and in fact he is an officer of the court, and that he has a direct duty to help look after it. He can do more even than the judge to maintain in the court room a simple, yet respectful, dignity. To this end may we not consider a few concrete suggestions?

When the judge enters the room, all should rise and wait to be invited to be seated. Except in the course of a trial, if a judge speaks to an attorney while the attorney is sitting the attorney should rise to answer the court. The proper way to address the court in the first instance is "May the Court please," not "If the Court please," and these words, of course, should be spoken while the lawyer is on his feet.

The judge will try not to tolerate personalities, and to aid in this effort to be abstract and impersonal, the lawyer should address the court in the third person, as "The Court will remember the testimony," not "You will remember, etc.," or "On the 5th instant the Court entered an order," not "On the 5th instant you entered an order." When the judge is on the bench, he should never be addressed as "You."

When the judge invites the lawyers into chambers, the lawyers should stand back and wait for the judge to enter first; and on returning to the court room, the judge should enter the court room first. In chambers, judge and counsel may be as informal as they

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